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SUBJECT: BRAZIL'S PROSPECTS FOR A RETURN TO ECONOMIC GROWTH

REFS: A) SAO PAULO 1835
B) BRASILIA 3405

¶1. SUMMARY. Brazil's government, economists and media all now voice expectation of forthcoming relative economic relief. Hardly anyone dissents from the forecast of 3/3.5% GDP growth in 2004. Optimists suggest a parallel with 2000, when Brazil's GDP grew 4.4% after the previous year's 0.7%, despite the context of a cloudy world economy, as real interest rates fell from 9 to 6 percent. The hopeful scenario today is for one or two quarters of upswing to be driven by consumer-credit expansion and long-deferred purchases of durable goods in response to the GoB's monetary easing since July, with the premise that this new consumption will induce fresh investment that would become Brazil's primary economic driver for the medium run, in turn spurring extra output, employment and consumer buying-power by 2005. Some unexpectedly good recent data for industrial output and capital-goods sales are consistent with this picture.

¶2. Market confidence in the GoB and in domestic political events seems quite sturdy. Calls for the Central Bank to relax monetary policy still faster have come from some surprising new quarters. But the GoB is plainly set on breaking Brazil's habit of bubble-and-inflationary-bust. It wants multi-year sustainable growth (which coincides with Lula's re-election interests), and won't be rushed. Investors view the status of Lula's pension and tax bills, however watered-down, as still adequate. Greater doubt exists as to the GoB's future microeconomic/regulatory reforms, upon which by general agreement vital investment will hinge. And Brazil's debt/GDP vulnerability remains on everyone's mind. The main worry is of a too-early U.S. monetary tightening. END SUMMARY.

Consensus on Growth

¶3. This cable reflects recent discussions in forty-plus meetings with GoB, market, and think-tank specialists in Brasilia, Rio and Sao Paulo during Treasury and EXIM visits. Interlocutors were drawn from a half-dozen foreign or domestic private banks, the Ministries of Planning, Finance and Trade, Treasury, multiple offices of the Central Bank, the Banco do Brasil, BNDES, Getulio Vargas Foundation, National Confederation of Industry, a major manufacturer, a top credit-rating agency, congress's tax committee, and elsewhere.

¶4. Without exception, sources agreed that Brazil's economy should grow 3% to 3.5% in 2004. All saw the ongoing drop in interest rates (with the benchmark SELIC down since June from 26.5% to an expected 18% on November 19) producing a marked, steady expansion of credit. Bradesco chief economist Osmar Pinho expected easing credit terms, coupled with traditional end-of-year bonuses and negotiated salary increases taking effect in January, to spark a near-term consumption mini-boom. Pinho thought a modest 20% increase in credit from its current depressed level sufficient to achieve the 2004 growth figure. Longer-term, he expected new investment to assume the role of central economic driver, pointing to Brazil's need for electrical generation capacity and ongoing telecom investment projects.

¶5. NOTE: Brazil's credit stock totaled Reals 390 billion in September -- almost exactly 25% of GDP. Hence, credit expansion of the order specified by Pinho would merely involve bringing the ratio back up to 30%. That would still be appreciably below the 32% of early 2002, when Brazil's economy was already hard-hit by the contractionary effects of Argentina's collapse, Brazil's own energy crisis, and 9/11. END NOTE.

¶6. CSFB's chief economist Rodrigo Azevedo likewise believed the monetary stimulus from falling interest rates and growing credit would carry the economy through the first two quarters of 2004 at a 3% rate. After that, investment would be needed to extend growth. Azevedo's counterpart at Banco Pactual, Guilherme Bacha, volunteered the view that the CB ought to be lowering interest rates still more aggressively, to better pump early consumption. Bacha (who reportedly was offered the post of CB Chairman after Lula's election but

turned it down in the belief that the GoB would accord him too little authority to ensure fiscal restraint), acknowledged with a grin that monetary loosening was the last recipe he would have prescribed in the PT government's first months, but explained that the GoB has so conclusively established its credibility that bolder cuts now would be risk-free.

¶7. In a related vein, Central Bank (CB) Governor for Monetary Policy Bevilacqua noted to us that Brazil has a historical record of swift, strong reaction to the early stages of monetary easing. Even with real interest rates (10-11%) still high by most standards, Brazilians have begun to make new buying decisions based on the CB's interest-rate cuts since June, averred Bevilacqua. He was careful to state that the CB does not necessarily see the current 10% as the economy's "equilibrium" real-interest rate. At the same time, he offered no hint of how fast or far the SELIC might fall in 2004. Rather, he stressed the GoB's unaltered resolution to preempt any possible reversion to what he termed Brazil's past "go and stop" pattern: too-carefree monetary easing fuelling good growth for a year or two, only to be followed by inflation's return and GDP slowdown.

¶8. Ministry of Finance Economic Policy Secretary Lisboa echoed Bevilacqua's thesis that the Brazilian economy reacts unusually quickly to interest-rate decreases. Separately, however, the IMF ResRep made plain to us his own disbelief that a sustained wave of consumption is on Brazil's near horizon. Other specialists note the likelihood that Brazil's much-increased current tax burden and real-income constraints will inhibit renewed spending far more than during Brazil's past historical episodes of monetary easing.

¶9. Nonetheless, some unexpectedly good recent statistics do accord with the GoB's optimism. Industrial production this September grew nationally by 4.2%, and in Sao Paolo by 5.7%, compared to September 2002. National vehicle sales in October were up by double-digit percentages for the second month in a row, admittedly helped by a recent GoB tax incentive. Encouragingly for near-term investment implications, capital-goods sales and imports were also both up strongly, month-on-month. Retail sales rose slightly in October, for the first time in fourteen months. In what the GoB claims as further evidence of overall recovery, October tax revenues rose twenty percent over September's. And Sao Paulo's industrial-sector employment surprised all observers by growing 0.5% (7,700 new jobs) in October, the best October result since 1994.

¶10. All private-sector contacts lavished uniform praise on the Lula government's macroeconomic policies for restoring credibility and bringing Brazil Risk (the spread above U.S. treasuries that Brazil must pay to borrow on international markets) down from over 24% in October 2002 to its current level of under 5.5%. A few acknowledged that part of this effect was simply because expectations for macroeconomic policy in a Lula government had started so low.

Main Hazard -- External Interest Rates

¶11. CSFB's Azevedo and others warned that Brazil's financial stabilization has benefited from an unusually benign international environment, with developed-country interest rates at very low levels. The flip side of the coin is that Brazil's debt-service burden (debt/GDP ratio still at 57%) leaves it prey to potential tightening of U.S. monetary policy. That could re-ignite last year's vicious cycle of currency depreciation, causing foreign exchange to exit or avoid Brazil anew and upsetting the GOB's carefully balanced fiscal apple cart. This risk may loom larger in light of the third-quarter U.S. growth figures.

¶12. Banco Pactual's Bacha was particularly emphatic that the main threat to Brazil's economic prospects in 2004-2005 would be a too-early initiation of U.S. Fed interest-rate hikes. Yes, Bacha admitted, such hikes would presumably be correlated with strong U.S. growth, which should fuel Brazilian exports. But, he said adamantly, the financial downside for Brazil would far outweigh any export-demand benefit. Asked at what stage U.S. interest-rate movement might become critical for Brazil, Bacha declined to quantify, opining just that world-market atmosphere at the time would be decisive.

¶13. In this context, minds are focused on the GoB's reduction of the dollar-indexed component of public debt. With the ongoing non-rollover of up to 12 billion dollars' worth of dollar-linked Brazilian domestic debt, that component may fall below 23% by year's end. Continuing this progress through next year is essential to keeping the dollar-linked debt from exerting undue pressure on fiscal accounts when the inevitable developed-world monetary tightening begins. As to overall debt-to-GDP ratio, GoB officials admitted that it will be marginally greater at the

end of 2003 than a year earlier, but maintained that from 2004 it will steadily fall.

Reform Uncertainties

¶14. The double-consensus of public and private sectors is that investment must carry growth in the longer term, and that that investment will hinge on macroeconomic and microeconomic/regulatory reforms. The question then is how quickly Lula's structural reforms advance and begin to bear fruit.

¶15. Given the delays, watering-down and remaining uncertainties of Lula's macroeconomic reforms -- i.e., the tax and pension bills -- we repeatedly asked if the market might at some point deem those reforms inadequate and react accordingly. The consistent answer was negative. Analysts explicitly said their companies are comfortable enough with the two bills' status. They agreed that their legislative progress has been underwhelming, and that the fiscal effect of each has been diluted to unimpressive dimensions. Few saw the pension-reform bill as doing much more than "stopping the fiscal bleeding." Alvaro Freire of Unibanco warned that all such politically sensitive reforms would be an iterative process, requiring years and multiple re-visits. But the simple fact that the PT had tackled pension and tax reform seriously remained positive and paramount.

¶16. One GoB reform to be unconditionally applauded was the new bankruptcy law, recently passed and sent to the Senate by the lower Chamber. Unibanco's Freire, among others, expected the bankruptcy law to have a fairly rapid effect in reducing banking spreads, although opinion was split on the size of that impact. On the subject of Brazil's regulatory and microeconomic framework for future investment (Ref B), we heard a perhaps surprising lack of comment. This applied most conspicuously to the future energy model and the reform of regulatory agencies' roles.

Not Too Much of a Good Thing

¶17. Several interlocutors noted that sustained growth above 4% would pose its own risks. Ministry of Finance International Secretary Canuto asserted that there is sufficient slack

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capacity in the economy to accommodate growth on the order of 3% to 3.5%. Beyond that level, bottlenecks and inflation would rear their heads. AmCham Economic Committee head Paulo Albuquerque raised a similar caveat. GOB officials spoke of their aim to alleviate some of these constraints by attracting private investment in infrastructure through new Public Private Partnerships (PPP) projects.

¶18. On the external-account side, renewed Brazilian growth could be expected to involve a return to current-account deficits, as imports rise from their currently depressed levels and with Brazil's exporters perhaps selling a greater share of output to a reviving domestic market. The standard estimate for these deficits, from both private economists and GoB specialists, was five-to-six billion dollars for 2004, and six-to-eight billion for 2005. Many observers noted the need for extra foreign investment to bridge these gaps.

COMMENT

¶19. To judge from these meetings, local prognoses for Brazil's economy are more homogeneously positive now than at any time in the last two years. We have our reservations. First, even granted that consumption has begun to pick up pre-Xmas, it seems debatable that Brazil's population has the income or savings for sustained buying after six successive years of annual real-wage decline. Second, the GoB's record to date in Congress has not been such as to inspire confidence in early achievement of the follow-on "microeconomic" reforms which by general account are a pre-condition for vital future investment (Septel). Third, the GoB itself, as Finance Minister Palocci is making newly clear, sees 2004 as being perhaps its most austere yet for discretionary budget expenditures -- no pump-priming likely from that quarter. Fourth, even 3.5% growth in 2004 would hardly begin to make up the ground lost in national income and employment in 2001-2003, with that period's annual growth rates of 1.8%, 1.5% and perhaps 0.6%, respectively.

¶20. Even in the smoothest scenario, the timeframe for new jobs and income to reach the sectors of Brazil's population that need them most still looks far-off indeed. It may look particularly so to PT party candidates and others planning to contest the October 2004 municipal elections.

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